RBC Global Asset Management

# Market Update

DECEMBER 2020

# Stocks climb to new records as vaccine developments draw normalization closer

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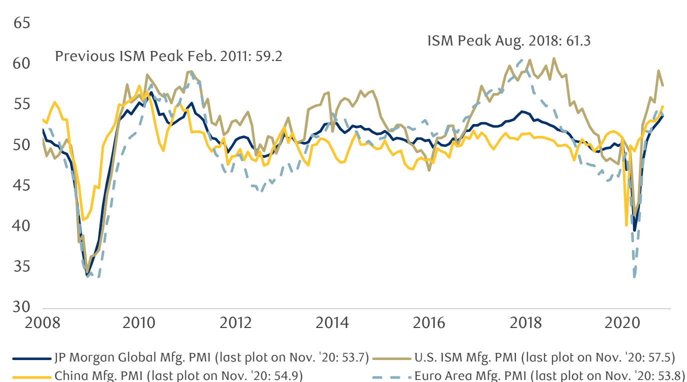
The global economy is progressing through a series of targeted lockdowns and subsequent re-openings as governments manage the delicate balance of people's health versus economic growth. Service sectors have been hit the hardest with restrictions on travel, restaurants and entertainment, but manufacturing activity remains robust and leading economic indicators point to expansion in regions where lockdowns have been less severe (Exhibit 1). Data releases have been better than expected and economies are showing impressive resilience. Growth may stumble a bit in the fourth quarter due to a flare up in COVID-19 cases, especially in Europe, but the promise of a vaccine clarifies the path to normalization and a better outlook for 2021. We are upgrading our growth forecasts for most regions, boosting our estimates slightly above the consensus.

Although vaccines are showing promise, challenges remain with respect to distribution and administration of the vaccine to the entire world's population. Vulnerable groups may receive the vaccine earlier, but we expect that the vaccine won't be widely available until the third quarter of 2021. Other potential risks include the transition of government in the U.S. and Brexit in Europe/U.K. Looking further out, unprecedented government spending during the pandemic has ballooned fiscal deficits challenging future economic growth. With all the stimulus delivered, inflation could rise somewhat in the medium to longer term, but several factors such as lower oil prices and high unemployment are likely to keep inflation pressures muted in the near term.

## Central banks maintain highly accommodative stance

With economies still grappling with the virus and little threat of inflation for now, central banks remain accommodative. There is no urgency to raise interest rates and many central bankers have expressed their intentions to keep interest rates low for an extended period. The Fed's own projections suggest U.S. short-term interest rates will remain at the zero lower bound at least until the end of 2023. Moreover, massive bond-buying programs remain in place to support the economy and financial markets.

### Exhibit 1: Global purchasing managers' indices




Note: As of December 1, 2020. Source: Haver Analytics, RBC GAM

## Sovereign bonds inch higher in some regions, still represent meaningful valuation risk

Although bond yields remain near historically low levels, they have inched higher in some regions as economies have gradually reopened and investor demand for safe-haven assets diminished. Sovereign yields are slightly higher in North America in the past quarter, but declined a bit in Europe given tightened measures to combat a second wave of COVID-19 infections. Bond yields are below our estimates of equilibrium in all major regions, indicating meaningful valuation risk (Exhibit 2). We look for yields to gradually rise over the longer term, but a number of secular factors including demographics, increased preference for saving versus spending, and the emergence of developing nations are likely to limit the extent of any increase.

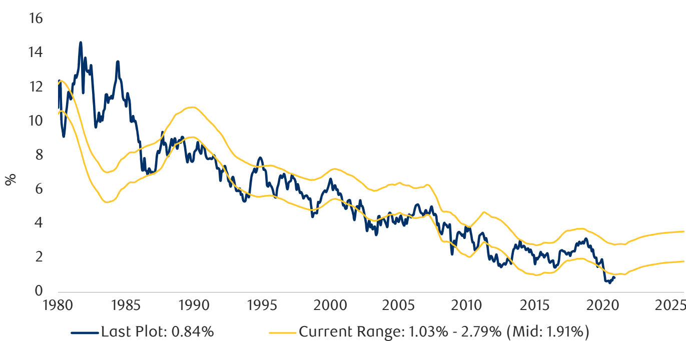
## Equities climb to record levels as vaccine news triggers style rotation within indices

Global equity markets extended their gains on optimism surrounding the positive vaccine news, sending several major market indices to record highs in November. While U.S. large-cap growth stocks led through most of the COVID-19 pandemic era, the most recent rally featured outperformance by small cap, value, and international equities (Exhibit 3). As a result, the valuation gap between U.S. large-caps and other equity markets narrowed slightly from extreme levels. That said, the S&P 500 remains the most fully valued of the major markets that we track (Exhibit 4). Markets outside of the U.S. large-cap space are still attractively priced according to our models as are many sectors and styles outside of the COVID-period leadership.

## Earnings exceed estimates and outlook improves

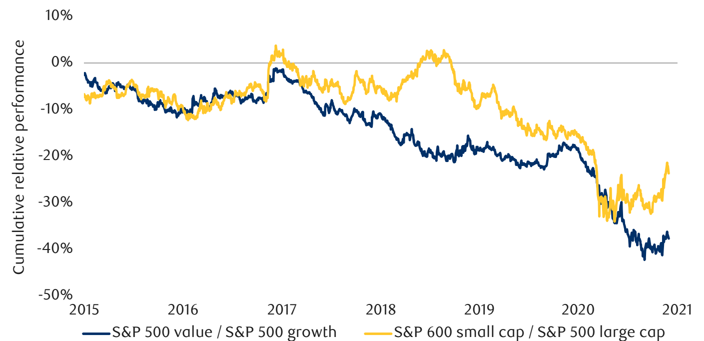
Corporate profits plunged amid the virus-induced recession, but the damage was not as much as initially feared and profits are already rebounding (Exhibit 5). Analysts currently look for S&P 500 earnings to decline 15% in 2020 compared to earlier expectations of a 25% drop. Analysts now forecast S&P 500 earnings growth of 20% in 2021 and for profits to reclaim their pre-COVID peak sometime next year.

### Exhibit 2: U.S. 10-year T-Bond yield
Equilibrium range



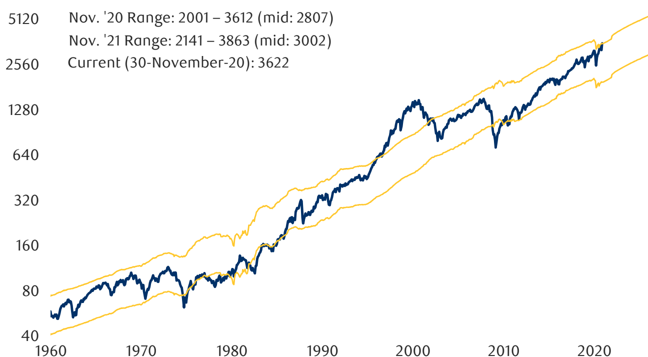

Note: As of November 30, 2020. Fair value estimates are for illustrative purposes only. Corrections are always a possibility and valuations will not limit the risk of damage from systemic shocks. It is not possible to invest directly in an unmanaged index. Source: RBC GAM, RBC CM

### Exhibit 3: Relative style performance




Note: As of November 30, 2020. Source: Bloomberg, RBC GAM

### Exhibit 4: S&P 500 equilibrium
Normalized earnings & valuations

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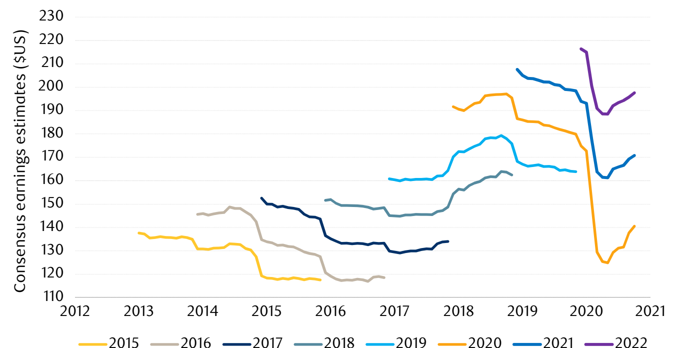
### Exhibit 5: S&P 500 Index
Consensus earnings estimates




Note: As of December 1, 2020. Source: Thomson Reuters, Bloomberg

### Asset mix – raising equity allocation, sourced from bonds

Our base case scenario sees the economy reclaiming its prior peak over the next one to two years and approaching its long-term growth trajectory in 2023, still supported by significant fiscal and monetary stimulus. In this environment, government bond yields should remain low. As a result, we expect very modest and potentially negative returns in sovereign bonds over the year ahead. Stocks, however, offer superior return potential and, while valuations are demanding, the vaccine provides greater certainty in a positive outcome. Moreover, a number of signs we would look for to confirm an improving outlook are falling into place. In recent months, the yield curve has steepened, value outperformed growth, international equities gained relative to U.S. stocks, small caps outperformed large caps and the U.S. dollar depreciated. These factors are consistent with the early stages of an economic cycle, indicating the bull market has room to run. For these reasons, during the quarter we increased our equity allocation by 2.5 percentage points in two separate moves, sourced from bonds. Our current recommended asset mix for a global balanced investor is 64.5% equities (strategic: "neutral": 60%), 34.5% bonds (strategic "neutral": 38%) and 1.0% in cash.

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Publication date: December 2, 2020